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Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The memorandum letter opinion and findings of fact and conclusions of law of the district court (Pet. App. A 1a-14a) are not reported. The opinion of the court of appeals (Pet. App. B 15a-30a) is reported at 536 F. 2d 746.

JURISDICTION

The judgment of the court of appeals was entered on May 26, 1976 (Pet. App. C 31a). On August 6, 1976, the court of appeals clarified the final sentence of its opinion, but otherwise denied petitioner's petition for rehearing with suggestion for rehearing *en banc* (Pet. App. D 32a-33a). The petition for a writ of certiorari was filed on November 3, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the decision below correctly held that the sale of a building to petitioner and the long-term lease of the property back to the seller did not confer upon petitioner any significant ownership interest in the property that would entitle it to income tax deductions for mortgage interest and depreciation, where the rent paid by the seller was equal to the mortgage payments; the seller had an option to repurchase the property for the cash advanced by petitioner, plus interest, and the balance of the mortgage loan; and the seller retained a reversionary interest in the land.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

STATEMENT

This case involves the federal tax consequences of a sale and leaseback transaction in which petitioner took title to a

building under construction by the Worthen Bank & Trust Company ("Worthen") of Little Rock, Arkansas, and simultaneously leased the building back to Worthen for use as its headquarters and principal banking facility.

The pertinent facts are undisputed. Petitioner is a corporation engaged in distributing household electronic products (I-R. 20-22).[1] In 1965, the Worthen Bank purchased land in downtown Little Rock, upon which it planned to construct an office building for its headquarters (Pet. App. A 3a-4a). Worthen originally intended to finance the construction itself, and to retain title to the building. However, it was unable to obtain the requisite approval from federal banking authorities to invest an amount greater than its capital stock in the proposed new bank premises (Pet. App. B 16a). See 12 U.S.C. 371d.[2] After abandoning a second plan under which it proposed to raise the necessary funds through the issuance of debentures by a wholly-owned subsidiary, Worthen decided to seek financing through the use of a conventional mortgage coupled with a sale and leaseback arrangement with a third party. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the plan after modifications (Pet. App. A 4a; Pet. App. B 16a).

Construction of the building began on September 15, 1967. At that time, Worthen had obtained commitments from First National City Bank of New York for interim construction financing, and from New York Life Insurance Company for long-term financing, subject to their approval of the party nominated by Worthen to hold title to the building (Pet. App. B 16a). After negotiations between

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[1] "I-R." and "II-R." refer to the two volume record appendix in the court of appeals.

[2] The estimated cost of the proposed building was $9,000,000, and Worthen's outstanding capital stock was $4,000,000 (Pet. App. A 4a).

Worthen and petitioner (whose principal shareholder was a director of Worthen) and other parties. Worthen selected petitioner as the party to hold title to the building. Worthen, petitioner, and the two lenders thereupon entered a series of interrelated agreements calling for petitioner to invest $500,000 in the building, which was to bear "interest" at six percent per year, with the balance of the cost of construction to be financed by a mortgage loan to be provided by New York Life, payable over 25 years (Pet. App. B 17a).

On May 1, 1968, Worthen executed a "ground lease" covering the underlying land to petitioner for a term of 75 years, with rentals for the first 25 years in the nominal amount of $50 per year. On May 19, 1968, petitioner agreed to purchase the building, as it was being constructed, at a price equal to the construction cost (not to exceed the amount of the $7,140,000 mortgage loan to be provided by New York Life plus $500,000). By agreement dated May 1, 1968, petitioner agreed to lease the building back to Worthen for a primary term of 25 years with annual rentals exactly equal to the principal and interest payments on the New York Life mortgage (Pet. App. B 16a-17a). Worthen's obligation to pay these amounts over the primary term was absolute and unconditional. Worthen also had the obligation to pay all expenses on the property (including taxes and insurance) and continued to bear all risks of loss (Pet. App. B 20a).

The lease agreement between Worthen and petitioner further provided that Worthen retained an option to repurchase the building at the end of the 11th, 15th, 20th and 25th years of the primary term of the agreement at a price equal to the unamortized principal balance of the New York Life mortgage plus petitioner's $500,000 investment, with interest compounded at six percent per year.[3] Worthen also

[3] The Arkansas State Bank Department required that such a leaseback arrangement provide for a repurchase option at the end of the 15th year, but did not otherwise specify the terms of the agreement (Pet. App. A 4a).

had the option to extend the term of the lease for up to 40 additional years at greatly reduced rentals, which were further offset by sharply increased ground rentals due Worthen for such periods. The net amounts payable by Worthen to petitioner over this extended term would yield a return on petitioner's $500,000 investment of slightly less than six percent (Pet. App. B 17a, 19a-20a).

Pursuant to these agreements, petitioner became the formal obligor on the interim and permanent loans provided by First National City Bank and New York Life. In accordance with Worthen's express consent, the lease agreement between petitioner and Worthen was given as security for those loans (Pet. App. B 18a).

On audit of petitioner's 1969 income tax return, the Commissioner determined that petitioner was not the owner of the Worthen building but that it was acting merely as a conduit for the transmission of interest payable on these loans from Worthen to the lenders. Accordingly, he disallowed petitioner's claimed deductions for mortgage interest and depreciation, and excluded the rental payments from its income (Pet. App. A 7a-8a).

In this refund suit brought by petitioner in the United States District Court for the Eastern District of Arkansas, the district court held that petitioner was entitled to be treated as the owner of the building for purposes of claiming tax deductions for mortgage interest and depreciation (Pet. App. A 1a-14a). The court of appeals unanimously reversed (Pet. App. B 15a-30a). It concluded that the transaction was "closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.*, [308 U.S. 252]" (Pet. App. B 28a) because the petitioner had no "significant ownership interest" in the building (Pet. App. B 30a). In the court of appeals' view, petitioner "served as a mere conduit for the mortgage payments made by Worthen to New York Life" and the "benefits, risks, and burdens" borne by petitioner with respect to that building

were "too insubstantial" to support its claimed status as the owner of the building (Pet. App. B 29a).[4]

ARGUMENT

I. The court of appeals correctly held that under this Court's decision in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, the sale and leaseback transaction did not confer upon petitioner any significant ownership interest in the building that would entitle petitioner to income tax deductions for mortgage interest and depreciation. In *Lazarus*, this Court unanimously held that the taxpayer could disregard the form of a sale and leaseback transaction where the economic benefits and burdens of ownership were retained by the purported seller-lessee, whose payment of "rentals" simply served to amortize the mortgage loan on the property. Thus, the Court permitted the seller-lessee to claim depreciation deductions on real property nominally titled in the lessor. Here, in a transaction that the court of appeals recognized to be "closely akin" (Pet. App. B 28a) to that in *Lazarus*, the decision below properly permitted the Commissioner likewise to disregard the form in favor of the economic substance of the arrangement and to disallow petitioner's claimed interest and depreciation deductions. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465.

As in *Lazarus*, the nominal seller of the property remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's investment. The "rental" payments made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 19a). Moreover, Worthen had an absolute obligation to make the

[4]On petitioner's petition for rehearing, the court of appeals modified its opinion to provide for a remand to the district court for further findings with respect to its claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a-33a).

rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a). Indeed, it was impossible for Worthen to terminate the arrangement because it expressly consented to the assignment of petitioner's interest in the lease as security for the loan.

Thus, Worthen's role in the transaction was identical to a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role in the transaction was simply that of a conduit to foward Worthen's mortgage payments, cast in the form of "rentals," to the mortgagee, New York Life. Under these circumstances, petitioner is not entitled to deductions for mortgage interest and depreciation because it had no ownership interst in the property.

Moreover, the repurchase options retained by Worthen further demonstrate that petitioner did not bear any of the benefits and burdens of ownership. Here, as in *Lazarus*, the purported seller-lessee (Worthen) had the option to repurchase the property for an amount equal to the unpaid mortgage balance and petitioner's investment, plus interest (see Pet. App. B 19a).[5] At stated intervals during the term of the agreement, Worthen could have stepped into the shoes of petitioner and acquired title to the building simply by assuming the mortgage and repaying petitioner's $500,000 investment plus interest. Since petitioner did not stand to benefit from any appreciation in the value of the building or

[5]Contrary to the district court's "finding" (Pet. App. A 6a) that the option prices represent the parties' "negotiated estimate * * * as to the fair market value of the building on the option dates," the record shows that these prices were geared precisely to the principal balance of the New York Life loan and the return of petitioner's $500,000 at the proposed "interest" rate of 6 percent (Pl. Ex. 13).

stand to suffer any loss from any decrease in its value, it did not own the building in any realistic sense of the word.[6]

Petitioner (Pet. 7, 15) seeks to minimize the significance of the option to repurchase by citing the district court's finding (Pet. App. A 6a) that it was unlikely that Worthen would exercise the option. But as the court of appeals correctly recognized (Pet. App. B 19a), the reason why Worthen might not exercise its option to repurchase at the end of the primary term, if not before, is that it had the right to occupy the building for an additional 40 years, retaining all of the benefits of ownership, at drastically reduced rentals, which would repay petitioner its $500,000 investment with a return of slightly *less* than six percent compounded interest. Moreover, since Worthen retained title to the underlying land, it was assured, in any event, of

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[6]Petitioner argues (Pet. 15-16) that it was not totally deprived of the prospect of realizing any appreciation on the building because the depreciation deduction would reduce its adjusted basis in the property so that it would enjoy taxable "appreciation" on its recovery of its $500,000 with interest on the exercise of an option by Worthen. But this argument assumes that petitioner is entitled to claim depreciation deductions, the very question at issue in the case. Moreover, such tax "appreciation" would have no relationship to the economic appreciation in the value of the building itself, because petitioner's return, on the exercise of Worthen's option, would never exceed a fixed return of 6 percent on its investment.

Petitioner also argues (Pet. 16) that it could have sold the building at a profit to third parties. But petitioner obviously could not sell the underlying land, and any sale of its interest in the building would be subject to the rights of Worthen. Hence, any profit on such a transaction would reflect appreciation in the value of petitioner's rights under the lease, and not the building itself. Finally, petitioner suggests (Pet. 16) that it would realize any appreciation on the destruction or condemnation of the property. In fact, the lease required petitioner to pay over any insurance or condemnation proceeds to Worthen as necessary to restore or replace the property. In the case of total destruction or taking after December 1, 1980, Worthen had the option either to replace or to repurchase the property at a price computed on the same basis as its outright repurchase options (Pl. Ex. 19, sec. 17).

recovering absolute possession and ownership of the property on the expiration of the ground lease a relatively short time after the end of the extended term of the building lease.[7] Cf. *Frito-Lay, Inc.* v. *United States*, 209 F. Supp. 886 (N.D. Ga.).

If, as the court of appeals noted (Pet. App. B 24a), the various obligations and rights of ownership are analogized to a "bundle of sticks," it is clear that Worthen held most, if not all, of the "sticks" and petitioner few or none. Since it is virtually inconceivable that Worthen would simply walk away from its investment in this building at the end of 25 years after it had fully paid for its construction (except for the return of petitioner's $500,000 investment), the only risk borne by petitioner was that Worthen would become insolvent. But that is nothing more than the risk which would be borne by the guarantor of a loan rather than the owner of real property. The court of appeals therefore correctly held that Worthen, and not petitioner, was the actual owner of the building and that petitioner was simply a conduit between Worthen and New York Life.[8] Accordingly, Worthen and not petitioner is entitled to claim deductions for mortgage interest and depreciation with respect to the building.[9] Accord: *Commissioner* v. *H. F.*

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[7]Contrary to petitioner's assertion (Pet. 16), the law of Arkansas is in accord with the general common law rule that, unless the parties agree otherwise, improvements to real estate made by the lessee return to the owner of the land on the expiration of the lease. *Williams* v. *Kirby School Dist. No. 32*, 207 Ark. 458, 181 S.W. 2d 488, 490.

[8]The mere fact that such payments were made through petitioner does not serve to allow it to deduct such amounts, when the loan was in actuality made for the benefit of Worthen. Cf. *Nelson* v. *Commissioner*, 281 F. 2d 1 (C.A. 5).

[9]Contrary to petitioner's assertion (Pet. 11), the denial of the depreciation and interest deductions is not "to catch [it] in a trap, and to give Worthen a windfall * * *." While the parties may have expected to receive certain tax treatment, that expectation hardly requires the

Neighbors R. Co., 81 F. 2d 173 (C.A. 6); *Leeds and Lippincott Co.* v. *United States*, 276 F. 2d 927 (C.A. 3); *Estate of Franklin* v. *Commissioner*, 38 A.F.T.R. 2d 6164 (C.A. 9).[10]

2. Contrary to petitioner's further argument (Pet. 8, 12), the decision below does not conflict with *American Realty Trust* v. *United States*, 498 F. 2d 1194 (C.A. 4). There, as here, the court of appeals examined the transaction in the light of the controlling legal standard established by this Court's decision in *Helvering* v. *Lazarus & Co., supra.* However, it concluded that the details of the arrangement were "sufficiently distinguishable from those in *Lazarus*" (*id.* at 1199). It therefore held that there was sufficient evidence to support a jury verdict that the purchaser-lessor in a sale and leaseback transaction had an ownership interest in the property so as to be entitled to include the rental payments in its income and deduct the mortgage interest and depreciation, and to qualify as a real estate investment trust. Here, the court of appeals like-

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Commissioner to adhere to the form rather than the substance of the transaction. See *Commissioner* v. *Duberstein*, 363 U.S. 278, 286. At all events, the denial of the deductions to petitioner will be mitigated by the exclusion of the "rentals" from its gross income. Likewise, whatever benefit Worthen received from depreciation will be ultimately offset by the disallowance of its "rental" payments, except to the extent they represent interest required to be paid to New York Life.

[10]Petitioner suggests (Pet. 10-11) that it should make no difference to the government whether it or Worthen claims the interest and depreciation deductions as long as both parties do not claim the same deductions. But the Commissioner is required to tax such transactions in accordance with their actual economic substance and not the formal labels adopted by the parties. While there may be particular instances in which an audit of both parties to a sale and leaseback transaction does not result in the collection of additional revenues, differences in the tax characteristics of the parties (*e.g.*, tax bracket, taxable status) may produce net deficiencies.

wise refrained from making a "general condemnation of sale-leaseback arrangements" (Pet. App. B 30a). But on the facts of this case, it held that "[t]he overall nature of this transaction is closely akin to that in [*Lazarus*]" (Pet. App. B 28a).

While both *American Realty Trust* and the decision below involve sale and leaseback transactions, the two cases are sufficiently distinguishable on their facts so that the differing results do not create a conflict "on the same matter" within the meaning of Rule 19(1)(b) of the Rules of this Court.

Unlike this case, it does not appear that the rental payments in *American Realty Trust* were precisely equal to the principal and interest payments on the underlying mortgage so as to establish the conduit role of the lessor that exists here. Indeed, the agreement in that case provided that the rent was to be reduced by only 50 percent of the reduction in the mortgage payments. Moreover, the agreement in *American Realty Trust* personally bound the seller-lessee to pay the rent only for the first six years of the 21-year lease and permitted him to assign the lease thereafter (see 498 F. 2d at 1195). Here, however, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding. There was accordingly no realistic possibility that petitioner would bear the risks of the rental market for the building.

Finally, unlike this case where Worthen could acquire title to the property either by exercising the repurchase option or by means of its reversionary interest, the lessee in *American Realty Trust* could only acquire title through the repurchase option. There, the court held that there was testimony tending to show that the lessee exercised his repurchase option "because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal" (*id.* at 1199). Given these distinguishing characteristics, the

court of appeals in this case correctly concluded that "[t]he arrangement * * * [in *American Realty Trust*] was not nearly so thin and transparent as the present transaction" (Pet. App. B 29a).[11]

3. Petitioner further argues (Pet. 9) that the decision below is contrary to the "essence of this Court's decision in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394." In *First Security Bank*, this Court held that the Commissioner could not exercise his authority under Section 482 of the Code to allocate insurance commissions to the taxpayer when it was prohibited by federal banking law from earning such commissions. Petitioner contends that Worthen cannot be deemed to be the owner of the building and the borrower of the money because it could not legally borrow the money. However, this case does not involve the conflict between the Commissioner's power to allocate income and federal or state restrictions on receipt of income considered in *First Security Bank*. But assuming *arguendo* that the banking law to which Worthen was subject might be relevant in determining the tax consequences of this transaction to petitioner (cf. Pet. App. B 30a), the federal banking law did not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities before making an investment in bank premises in an amount greater than its outstanding capital stock. See 12 U.S.C. 371d. Since the federal and state banking authorities approved the sale and

[11]Petitioner also argues (Pet. 9, 13) that the decision below conflicts with *Cubic Corporation* v. *United States*, 38 A.F.T.R. 2d 5717 (C.A. 9). That case did not involve a sale and leaseback transaction. There, the court held that a particular lease-option agreement for machinery was not a conditional sale where the agreement specifically provided that it should not be construed as a conditional sale contract and there was no evidence as to the fair market value of the machinery or of the option. See *Cubic Corporation* v. *United States*, 34 A.F.T.R. 2d 5895, 5897 (S.D. Cal.).

leaseback transaction (see Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here.

4. Finally, petitioner contends (Pet. 14-17) that the court of appeals improperly reversed the district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P. 52(a) protected the district court's finding that the parties intended the transaction to be a sale and leaseback with option to repurchase (see Pet. App. A 2a). See also *Commissioner* v. *Duberstein*, 363 U.S. 278. But the court of appeals did not dispute the district court's finding as to the intent of the parties. It therefore did not violate the "clearly erroneous" rule of Rule 52(a). Rather, the court of appeals concluded, as a matter of law, that the agreement was "simply too insubstantial to establish [petitioner's] * * * claim to the status of owner for tax purposes" (Pet. App. B 29a). In this respect, its decision is in accord with the other courts of appeals which have held that the question whether such agreements are the sales or financing transactions is one of law. *American Realty Trust* v. *United States, supra*, 498 F. 2d at 1198; *Estate of Franklin* v. *Commissioner, supra*, 38 A.F.T.R. 2d at 6165, n. 3; *American National Bank of Austin* v. *United States*, 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States*, 426 F. 2d 115, 117-118 (C.A. 6), certiorari denied, 400 U.S. 827.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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